

# **Board of Governors of the Federal Reserve System**

## **REPORT ON THE FAILURE OF THE OAKWOOD DEPOSIT BANK COMPANY**



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### **OFFICE OF INSPECTOR GENERAL**

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BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

October 25, 2002

The Honorable Susan S. Bies  
Chairperson  
Committee on Supervisory and Regulatory Affairs  
Board of Governors of the Federal Reserve System  
Washington, DC 20551

Dear Governor Bies:

We are pleased to present our *Report on the Failure of the Oakwood Deposit Bank Company* (A0202). The objectives of this review were established by section 38(k) of the Federal Deposit Insurance Act which requires the Inspector General of the appropriate federal banking agency to review the agency's supervision of certain failed institutions to:

- ascertain why the institution's problems resulted in loss to the Bank Insurance Fund (BIF), and
- make recommendations for preventing any such loss in the future.

The Oakwood Deposit Bank Company (Oakwood) failed because a massive and pervasive fraud was perpetrated by a trusted senior executive who exploited a weak corporate governance environment and inadequate internal control structure. We recognize that such a fraud can be difficult to detect, particularly when it involves senior executives in trusted positions, and that the examination process is not necessarily designed to detect every possible fraud. Nevertheless, we found that Federal Reserve examiners did not properly apply risk-focused examination principles that warranted more in-depth testing, even though they had identified significant internal-control weaknesses and a lack of responsiveness to regulatory criticisms by Oakwood management. Examiners also relied on the work performed by an outside Certified Public Accountant (CPA), who was viewed as both the internal and external auditor, without reviewing or assessing the CPA's work.

We also found that examiners overlooked obvious red flags that we believe could have led to uncovering the fraud earlier and may have reduced the loss to the BIF. While we did not identify any deficiencies in the Federal Reserve's supervisory guidance and procedures, we believe that lapses in appropriately applying the risk-focused approach to Oakwood's examinations were caused by the oversights of an inexperienced examination staff that was inadequately supervised and failed to consistently exercise appropriate professional skepticism.

Our report provides a number of lessons to be learned that we believe will be of value to staff and managers involved in planning and conducting community bank examinations. We are not making formal recommendations because our observations were based only on the experience of one failed institution. In addition, we have presented several matters for the Board's consideration that we believe could enhance the System's bank examination process.

Appendix 2 contains the Director of the Division of Banking Supervision and Regulation's response to a draft copy of this report. The director welcomed our report's contribution to understanding the Oakwood failure, and indicated that the Federal Reserve will carefully review the lessons to be learned and matters for consideration of the Board. He also noted that the Board and the Federal Reserve Bank of Cleveland were already in the process of implementing a number of corrective measures and procedures. He stated that Oakwood's failure provides a vivid reminder of the critical importance of effective execution of risk-focused examinations and the need to continually review supervisory process and procedures.

Copies are being provided to the appropriate House and Senate Committees, the Comptroller General of the United States, the Chairman of the Federal Deposit Insurance Corporation, and the Superintendent of Financial Institutions, State of Ohio Division of Financial Institutions. The report will be added to our public web site, and a summary will appear in our semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Barry R. Snyder". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Barry R. Snyder  
Inspector General

cc: Vice Chairman Roger W. Ferguson, Jr.  
Governor Mark W. Olson

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## **BACKGROUND**

The Oakwood Deposit Bank Company (Oakwood), a small, two office community bank located in rural Paulding County, Ohio, originally opened in 1905. This state-chartered member bank of the Federal Reserve System reported assets totaling approximately \$72.3 million on December 31, 2001. Oakwood was owned primarily by its board members and individuals within its local community, and focused its business on handling the banking needs of local residents. In addition, the bank provided basic financial services to the school district, municipal government, and county hospital.

Oakwood was closed by the Superintendent of the State of Ohio Division of Financial Institutions (State of Ohio) on February 1, 2002, after the bank's Executive Vice President, Mr. M. Steven Miller (Miller) confessed to fraudulent activity of sufficient magnitude to render the bank insolvent. The Federal Bureau of Investigation arrested Miller after he made the confession, and charged him with violating 18 United States Code section 656 "Theft, Embezzlement, or Misapplication by a Bank Officer or Employee." Miller was indicted by a grand jury and entered a plea of not guilty. The criminal case against him is pending.

In a letter dated April 26, 2002, the Federal Deposit Insurance Corporation's (FDIC) Inspector General advised us that the FDIC had determined that the Oakwood failure would result in a material loss to the Bank Insurance Fund (BIF) as defined under section 38(k) of the Federal Deposit Insurance Act (FDI Act). Under section 38(k) of the FDI Act, a loss to the BIF is considered material if it exceeds the greater of \$25 million or 2 percent of the institution's total assets. Section 38(k) also requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of the failed institution. As of early October 2002, FDIC estimated that the Oakwood failure would result in a \$60 million loss to the BIF.

## **OBJECTIVES, SCOPE, AND METHODOLOGY**

Section 38(k) of the FDI Act requires the Inspector General of the appropriate federal banking agency to review the agency's supervision of the failed institution to:

- ascertain why the institution's problems resulted in loss to the BIF, and
- make recommendations for preventing any such loss in the future.

To accomplish these objectives, we conducted interviews and collected data at the Board of Governors of the Federal Reserve System (Board), Federal Reserve Bank of Cleveland (FRB Cleveland), State of Ohio, and the FDIC Division of Resolutions and Receiverships (DRR). We also interviewed two former employees of Oakwood. We reviewed investigative files developed by federal law enforcement agencies along with supervisory records including surveillance reports, correspondence, examination reports, and available work papers for the five-year period preceding the bank's closure. We also analyzed Oakwood records collected by the FDIC after the bank was closed to corroborate statements Miller made to investigators regarding how he perpetrated the fraud. We have not disclosed certain details associated with the Oakwood fraud



because they are part of ongoing criminal investigations. Our work was conducted in accordance with generally accepted government auditing standards.

## **FRAUD CAUSED OAKWOOD TO FAIL**

Oakwood failed because of losses attributed to a check kiting scheme allegedly facilitated by Miller and embezzlements allegedly committed by him. These losses far exceeded the institution's stated capital that a December 31, 2001, regulatory filing listed at approximately \$6.4 million. Our review of bank documentation and discussions with former bank employees revealed that Miller had the authority as the bank's senior officer to initiate, approve, and record the bank's transactions. Because he was the dominant force in the bank and had the complete trust of Oakwood's board of directors, Miller was able to exploit the bank's weak internal control structure and inadequate separation of duties to systematically manipulate the bank's accounting systems and reports and conceal the fraudulent activity.

Oakwood began receiving heightened examiner attention in late November 2001 after the bank made several large borrowings from the FRB Cleveland's discount window.<sup>1</sup> Over a one-week period, Oakwood borrowed more than \$9.6 million from the discount window, \$5.8 million of which was reportedly used to cover returned checks. This unusual borrowing activity prompted examiners to make an on-site visit during which evidence presented by examiners resulted in Miller revealing that two of the bank's customers were engaged in check kiting activity.

Check kiting fraud takes advantage of the time required by a bank to clear a check, and generally involves the following scheme: A check drawn on one bank is deposited in a second bank, but the depositor does not have sufficient funds in the first bank to cover the check. When the check is deposited, the second bank grants the depositor conditional credit and allows the customer to draw checks against uncollected funds. The customer then writes a check on the second bank and deposits it in the first bank to cover the original check. Unless detected, this process can continue indefinitely, covering one check written against insufficient funds with another check. FRB Cleveland staff told us that Miller allowed the check kite to operate and continued to pay on uncollected funds to avoid unwanted attention from bank examiners.

After verifying the existence of the check kite, examiners from FRB Cleveland and the State of Ohio called an emergency meeting of Oakwood's board of directors on December 4, 2001, to disclose to them the bank's exposure to potential losses. On December 18, 2001, FRB Cleveland and the State of Ohio issued a joint supervisory letter which required the Oakwood board to (1) cease payment on uncollected funds, (2) freeze the lines of credit for both accounts involved in the check kite, and (3) file suspicious activity reports (SAR) for both accounts as required under the Board's regulations.<sup>2</sup> In addition, FRB Cleveland examiners instituted daily account monitoring for the two accounts and associated lines of credit.

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<sup>1</sup>Federal Reserve Bank discount windows are available to provide short term secured credit for depository institutions that need to adjust their reserve balances in light of unexpected changes in their assets and liabilities.

<sup>2</sup> 12 CFR Part 208, Subpart F, requires financial institutions supervised by Federal Reserve to submit a SAR to report known or suspected criminal law violations or other suspicious activities.

FRB Cleveland examiners made another on-site visit on January 28, 2002, after monitoring of the Oakwood accounts revealed that the check kite was continuing. Additional analysis performed by the examiners uncovered other questionable transactions that Miller could not adequately explain. When pressed on these issues, Miller confessed that he embezzled over \$40 million of the bank's resources and covered losses associated with the check kite. The check kite involved an estimated loss ranging from approximately \$8 million to \$11 million, and by itself was sufficient to make the bank insolvent.

With respect to the embezzlement, our analysis of cashiers checks and wire transfers revealed that the vast majority of stolen funds? approximately \$40 million? went to a casino boat operation headquartered in Myrtle Beach, South Carolina. Miller and related parties owned an equity interest in this venture. The Federal Bureau of Investigation, the Internal Revenue Service-Criminal Investigation, FDIC Office of Inspector General, and the United States Attorney for the Northern District of Ohio are currently investigating other defalcations amounting to more than \$9 million.

Our analysis of bank documents and discussions with FDIC's DRR staff revealed that Miller used the proceeds from Certificates of Deposits (CDs) advertised over the internet as the primary source of monies embezzled. In late 1998, the Oakwood board of directors approved a pilot project for expanding the bank's deposit base by marketing CDs over the internet. Soon after the pilot got underway, the Oakwood board decided against pursuing this line of business. Despite the board's instructions, Miller continued to sell CDs advertised over the internet, mostly in denominations of \$99,000-\$100,000 with two-year maturities. CD purchasers included other banks, credit unions, or brokerage firms purchasing CDs on behalf of their clients. These CDs generally had a comparatively favorable interest rate that Miller would adjust to attract funds as needed.

When the funds were deposited at Oakwood, Miller would record the CD on the bank's books. He would then manipulate the bank's records to show that the CD had been paid off. The bank documents we reviewed confirmed that a number of accounts and processes were used to conceal the fraudulent activity. This included moving funds into and out of the account called, "other assets and other liabilities," using either standard accounting transaction procedure or an on-line terminal that allowed Miller to directly alter Oakwood's official records.

Our analysis of Oakwood's records and discussions with former Oakwood staff suggest that Miller recognized that manipulating CD accounts could cause a problem if a customer called the bank to redeem a CD early or inquired about their balance. The bank staff we interviewed told us that Miller made it clear that he would personally handle any calls regarding problems with CD balances. According to former employees, Miller would review the CD documentation, make a quick calculation, and provide inquiring customers with the correct principal and interest balances.

# SUPERVISION OF OAKWOOD

The Federal Reserve uses a risk-focused approach that tailors supervisory activities to address issues that pose the greatest risks to an institution's viability and strives to maximize the effectiveness of examiner resources. Under the risk-focused approach, examiners evaluate the safety and soundness of a financial institution by assessing its risk-management systems, financial condition, and compliance with applicable laws and regulations. Examiners use a variety of inputs to determine the level of reliance that should be placed on the institution's risk assessments and internal control systems. Accordingly, examination objectives are often based on (1) surveillance data that compares institutions to their peers, (2) prior examination reports, (3) internal and external audit reports, (4) press releases, and (5) the results of preexamination visits that usually take place six weeks before examiners begin their on-site work.

In order to operate in a safe and sound manner, banks are expected to establish a management and internal control structure that adequately identifies, measures, monitors, and controls its risks. In turn, examiners are expected to perform sufficient testing to determine the degree of reliance that can be placed on the bank's internal control systems. According to guidance on the risk-focused approach included in the Federal Reserve's *Commercial Bank Examination Manual* (manual), additional testing must be performed when examiners determine that the risk-management processes or internal controls are considered weak because of inadequate separation of duties or other problems identified during an on-site examination. The manual also notes that substantial on-site testing should be performed if an examiner believes that a banking organization's management is being less than candid, has provided false information, or has omitted material information.

## Oakwood's Supervision History

From 1996 through 2002, the period covered during our audit, the State of Ohio and FRB Cleveland conducted one targeted and four full-scope examinations (see table 1). The Federal Reserve and State of Ohio examiners were responsible for leading examinations in alternate years. While FRB Cleveland led the targeted examination conducted in October of 2000, the 2001 examination was conducted on a joint basis.

**Table 1** **Oakwood Examination Results**

<b>Start Date</b>	<b>Composite Rating *</b>	<b>Lead Agency</b>	<b>Scope **</b>
09/13/1996	2	FRB Cleveland	Full
06/22/1998	2	State of Ohio	Full
01/10/2000	3	FRB Cleveland	Full
10/30/2000	--	FRB Cleveland	Targeted
02/20/2001	2	FRB Cleveland/ State of Ohio	Full
*Refer to appendix 1 for definition of CAMELS composite ratings.			
**A full-scope examination is a comprehensive review of a state member bank. Targeted examinations generally focus intensively on business lines, relevant risk areas, and/or areas of significant supervisory concern during the supervisory cycle.			

As shown above in table 1, Oakwood continued to receive a CAMELS composite rating of 2 until the 2000 examination, when it was downgraded to a CAMELS composite rating of 3. This lower rating reflected examiner concerns that management did not correct operational and loan-administration weaknesses cited in prior reports of examination. FRB Cleveland examiners initiated an informal supervisory action requesting that the Oakwood board of directors adopt resolutions to address the deficiencies outlined in the 2000 *Commercial Bank Report of Examination*.

Supervisory concerns about Oakwood were also reiterated in a surveillance document prepared by the FRB Cleveland two weeks before they led an October 30, 2000, targeted examination that, among other things, focused on the bank's progress in addressing issues raised in the informal supervisory action. The surveillance report noted that:

**Administration and supervision of the bank by management and the board of directors has been inadequate. Management has not been responsive to regulatory criticisms from previous examinations.**

Examiners returned less than three months later to conduct a joint full scope examination. After being satisfied that the deficiencies noted in the 2000 *Commercial Bank Report of Examination* were rectified, Oakwood's CAMELS rating was upgraded to a composite 2. Also, in March 2001, examiners concluded that the terms of the board resolutions were fulfilled and the informal supervisory action was rescinded. There were no other supervisory actions until December 2001, when, as noted above, examiners required another set of board resolutions related to check-kiting activities between two of the bank's customers.

## **FINDINGS, CONCLUSIONS, AND LESSONS TO BE LEARNED**

Oakwood failed because weak corporate governance and an inadequate internal control structure created an environment that allowed a trusted senior executive to perpetrate a massive and pervasive fraud. We recognize that such a fraud can be difficult to detect, particularly when senior executives in trusted positions systematically cover their tracks by forging or hiding key documents and manipulating financial records. In addition, the examination process is not necessarily designed to detect every possible fraud. Nevertheless, we found that examiners did not properly apply risk-focused examination principles that warranted more in-depth testing and verification, even though they had identified significant internal control weaknesses and a lack of responsiveness to regulatory criticisms by Oakwood's management. Examiners also relied on the work performed by an outside Certified Public Accountant (CPA), who was viewed as both the internal and external auditor, without reviewing or assessing the scope, methodology, and reliability of the work. We also found that examiners overlooked obvious red flags that we believe could have led to uncovering the fraud earlier and may have reduced the loss to the BIF. While we did not identify any deficiencies regarding the Federal Reserve's supervisory guidance and procedures, we believe that lapses in appropriately applying the risk-focused approach to Oakwood's examinations were caused by the oversights of an inexperienced examination staff that was inadequately supervised and failed to consistently exercise appropriate professional skepticism.

We are aware that observations regarding the supervision of one failed bank do not necessarily constitute sufficient evidence for making broad-based recommendations. Nevertheless, our discussions with Reserve Bank officials regarding current supervisory practices indicates that the Oakwood failure offers lessons learned that would be of value to staff and managers involved with community bank examinations.

In our view, one of the key lessons learned from the Oakwood failure relates to recognizing risks and factoring them into examination planning. At first glance, Oakwood does not appear to be an institution that would pose inordinate supervisory concern. It was a relatively small, (less than \$100 million in assets) seemingly stable, rural institution with a senior manager who worked at the bank for over twenty-five years. In addition, Oakwood was a longstanding state member bank that had been examined by FRB Cleveland and the State of Ohio for decades. Moreover, Oakwood appeared to have a strong capital position, as measured by a variety of standard ratios, and until the 2000 examination, usually received composite CAMELS ratings designating the bank as fundamentally sound. The seemingly stable appearance, however, belied the bank's critical internal-control deficiencies that enabled significant undetected fraud. We believe that a primary lesson to be learned from the Oakwood failure is that banks with

- a weak board of directors,
- dominant senior executive,
- inadequate separation of duties,
- a weak or non-existent internal and external audit program, and
- a history of internal control deficiencies,

should be acknowledged as high-risk institutions. Banks with these problems should be subjected to more intensive supervisory scrutiny including detailed reviews and testing of key accounting transactions and the internal control environment.

We believe that the Oakwood failure also highlights the need for examiners to carefully evaluate work performed by internal and external auditors. The results of such evaluations should be used to determine the level of testing that will be necessary during the on-site examination. According to the manual, the examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. At Oakwood, an outside CPA was engaged to perform internal audit work and review financial statements. Although examiners reported that the work of the outside CPA was "satisfactory," our review of examination workpapers and discussions with Reserve Bank managers revealed no such review or assessment of the CPAs work was ever performed by the examiners. Furthermore, even a cursory review of the CPA's reports should have raised questions about the work's usefulness. For example, in the 1999 and 2000 reports disclosing the results of work requested by Oakwood's board of directors, the CPA stated:

**We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the Oakwood Deposit Bank's financial statements or specified elements, accounts, or items thereof. Accordingly, we do not express such an opinion. Also we express no opinion on the effectiveness of the Oakwood's Deposit Bank's internal control over financial reporting or any part thereof.**

Had examiners followed supervisory guidance, their review of the CPA's work should have resulted in recognizing the need to include detailed testing as part of their examination scope. At a minimum, such detailed testing could have increased the odds for earlier discovery of the fraud.

In addition to not translating Oakwood's internal-control deficiencies and the absence of audit coverage into an examination scope that included enhanced testing, examiners also either missed or did not follow up on obvious red flags that were evident in the 2000 and 2001 examinations. Our review of examiners' resumes and discussions with FRB Cleveland managers revealed that in both examinations, the red flags were missed by one of the team's least experienced examiners. The manual notes that experienced personnel must review all workpapers prepared during an examination. The two primary purposes of a workpaper review by senior personnel are to determine that the work is adequate given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. We saw no evidence that Oakwood's examination workpapers were subject to a sufficiently detailed review at any level. The red flags overlooked during the Oakwood examinations demonstrate the importance of ensuring that the work of less experienced examiners is appropriately reviewed by managers or more senior colleagues.

With respect to the red flags, our review of the 2000 examination workpapers disclosed that a 1999 year-end report on demand deposits showed that one of the bank's larger borrowers had a checking account with a deficit balance of \$76,000. The report also revealed that the account was overdrawn 110 days during the year, fifteen of which were on consecutive days. The report also showed that 432 items were presented for payment when the account had insufficient funds to pay the obligations. Such data could indicate the existence of a check kiting scheme. It appears that the examiner responsible for reviewing deposit accounts acknowledged the existence of these red flags because there is the notation, "OK", written next to the account. There is no documentation or discussion in the workpapers indicating the basis for this conclusion. In addition, there was nothing in the examination workpapers documenting work that was performed in following up on these overdrafts, and procedures that would apply when a potential problem of this magnitude is surfaced were not followed. The information regarding these overdrafts should have been provided to the examiner reviewing Oakwood's loan portfolio, who, in turn, should have questioned the loan officer handling the account. According to a FRB Cleveland examination manager, this borrower's loan should have been downgraded.

We believe that the information on the overdraft report should have raised suspicions of potential check kiting and prompted a referral for thorough investigation by an examiner with specialized expertise in bank fraud. Based on our review of Oakwood's records, an investigation into this matter would have likely uncovered additional red flags, and could have led to discovering

fraudulent activity earlier. Clearly, an earlier discovery of the fraud would have resulted in a smaller loss to the BIF.

The examiner assigned to review Oakwood's wire transfer operations apparently did not recognize another red flag, found during our review of the 2001 examination workpapers. We observed that a log documenting wire transfers into and out of Oakwood included an unusually large number of transactions and high-dollar volume of activity over only a two-day period. In all, the log showed two dozen wires totaling approximately \$5 million dollars, with many of the transactions for \$99,000 and \$100,000, amounts that are typical for CDs. FRB Cleveland managers confirmed that the volume, nature, and denominations of these transactions were highly irregular for a bank of Oakwood's size. We believe that the data found on the wire transfer log should have prompted a more in-depth analysis in order to trace and understand the context, nature, and ramifications of these unusual transactions.

## **MATTERS FOR THE BOARD'S CONSIDERATION**

In addition to the lessons learned above, we made observations that we believe could enhance the System's bank examination process. We are not making formal recommendations because these observations were based only on the experience of one failed institution. Instead, we are presenting what we found as matters for the Board's consideration.

### **1. Use the Fraud Information Network (FIN) to communicate lessons learned from the Oakwood failure.**

We believe the Oakwood failure offers some important supervisory lessons learned that Federal Reserve System examiners may find useful in planning and conducting future examinations of community banks with similar characteristics. It would appear that the Division of Banking Supervision and Regulation's (BS&R) FIN web page could be the ideal vehicle to communicate the Oakwood lessons learned. Created in August of 2001, FIN's mission is to

- facilitate the use of system fraud specialists to address potential issues of fraud within the System;
- serve as a communication resource on issues related to financial crimes, including trends and emerging issues;
- monitor fraudulent activity throughout the System; and
- develop examiner knowledge on financial fraud.

Examples of items included on the FIN web page that would accommodate information related to the Oakwood situation include fraud alerts, fraud incident reporting, red flags and lessons learned.

## **2. Expand the use of surprise examinations.**

FRB Cleveland generally notifies institutions of an impending examination at least six weeks in advance, around the time that the examiner-in-charge makes an on-site preexamination visit. We were told that Federal Reserve Banks throughout the System rarely conduct surprise examinations. Our review of Oakwood's financial records indicated that Miller was well aware of the Federal Reserve's examination schedule, and that he actively manipulated bank records in the weeks leading up to the on-site work. In response to their own lessons learned from the Oakwood failure, FRB Cleveland has already conducted a surprise examination at an institution that had weak internal controls. We believe that surprise examinations are a valuable supervisory tool that should be used more often, particularly in small community banks with characteristics similar to those observed at Oakwood.

## **3. Consider requiring independent financial statement audits for small community banks with weak risk management processes and internal controls.**

Banks with less than \$500 million in assets are not required to obtain an annual financial statement audit. However, federal bank regulators have issued guidance encouraging these institutions to adopt an external auditing program as a part of their overall risk management process. We believe an independent financial audit for institutions with questionable risk management and controls would enhance the probability that financial statements and reports to regulators and other financial-statements users will be accurate. Such an audit could also be useful for both detecting and preventing fraud.

## **4. Enhance examiner training in fraud and internal control testing and reconciliation techniques.**

Among other activities, participants in the System's FIN have been developing a fraud training module. Because the FDIC already offers basic fraud identification training, FIN participants are looking into coordinating the Board's fraud training efforts with the FDIC and the other federal bank regulators. We endorse FIN's efforts to develop a fraud training course and believe that it should be integrated into the basic examiner training curriculum.

FRB Cleveland examination managers told us they believe there is a need to reemphasize, through training, the importance of basic examination tools such as reconcilements and other transaction-testing techniques. The Federal Reserve Bank of St. Louis is developing a web-based training program entitled, "Examining Bank Operations," that will include modules to fulfill this need. The training targets, but is not limited to, examiners with less than three years of experience, and is due to go on line in early December 2002.



## ANALYSIS OF COMMENTS

We provided a draft copy of this report to the Director of BS&R for his review and comments. In his response, included as appendix 2, the director indicated that the Federal Reserve will carefully review all the matters and lessons outlined in our report and will see that the report receives a wide distribution to all examiners. In addition, the director stated that the lessons learned and red flags we identified will be incorporated into the supervision function's new Fraud Information Network and that representatives from FRB Cleveland and our office will discuss matters raised in our report at a major Systemwide conference early next year. The director also indicated that while the use of surprise examinations and requiring financial statement audits of banks with weak risk management systems and internal controls have long been available supervisory tools, in light of the Oakwood situation, BS&R will consider whether additional guidance for implementing these measures is needed. He also indicated that efforts to bolster training in fraud and internal control testing are already underway and that FRB Cleveland has already implemented a number of corrective measures and procedures. The director concluded his comments by stating that supervisors are daily faced with judgements on how to allocate their most experienced staff to a wide range of risks and competing demands. Nevertheless, Oakwood's failure provides a vivid reminder of the critical importance of effective execution of risk-focused examinations and the need to continually review supervisory process and procedures.

## **Appendixes**



## **Appendix 1- CAMELS Rating System**

On December 20, 1996, the Board of Governors of the Federal Reserve System adopted a revised Uniform Financial Institutions Rating System that was originally adopted by the Board in 1979. Over the years, this system has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. The rating framework also assists the public and Congress in assessing the aggregate strength and soundness of the financial industry.

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

### **COMPOSITE RATING DEFINITION**

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

#### **Composite 1**

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management.

#### **Composite 2**

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

## **Appendix 1- CAMELS Rating System (con't)**

### **Composite 3**

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

### **Composite 4**

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

### **Composite 5**

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

## Appendix 2 – Division Director’s Comments

### BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

#### Division of Banking Supervision and Regulation

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**Date:** October 23, 2002  
**To:** Barry R. Snyder, Inspector General  
**From:** Richard Spillenkothen, Director, Division of Banking Supervision and Regulation  
**Subject:** *Draft Report on the Failure of the Oakwood Deposit Bank Company*

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The staff of the Division of Banking Supervision and Regulation has reviewed the draft Report on the Failure of the Oakwood Deposit Bank Company prepared by the Office of Inspector General (IG) in accordance with section 38(k) of the Federal Deposit Insurance Act. The report notes that this community bank failed due to a pervasive criminal fraud carried out by a dominant individual who had the complete trust of the board of directors and who falsified bank records on a massive scale through his exploitation of the bank’s weak internal control structure and inadequate separation of duties.

The IG report does not identify general deficiencies regarding the Federal Reserve’s guidance and procedures pertaining to risk-focused supervision. The report does, however, address issues regarding the conduct of the examinations in the particular case of Oakwood and the day-to-day oversight of the staff who carried out the examinations.

The examination process cannot detect all frauds, but supervisors can and do attempt to identify the types of weaknesses in internal systems and controls that increase the possibility that fraudulent schemes can succeed. In this regard, the lessons and red flags discussed in the IG report on the Oakwood failure should be important and familiar ones for all examiners and supervisors.

In particular, this case highlights the importance of effective management oversight in establishing the appropriate scope of individual examinations and in assessing the validity of examiner findings before they are deemed to be complete. Managers of the examination process need to ensure an appropriate level of transaction and control testing, which can increase the odds (though by no means guarantee) that fraud will be detected at an earlier stage. This, in turn, may prevent a bank’s failure or, possibly, reduce the cost of its resolution.

It is important to note that in this case the Cleveland Reserve Bank responded very swiftly to the issues identified by the IG report and has already implemented a number of corrective measures and procedures. These steps will also be reviewed with other Federal Reserve Banks. More broadly, quality control and assurance are the highest priorities within the Federal Reserve, and Board staff will continue to emphasize and assess the important role of line

## **Appendix 2 – Division Director’s Comments (con’t)**

management in the execution of effective risk-focused examinations and core supervisory programs throughout the System.

The IG report does not make formal recommendations because it is based upon the experience of one failed institution. However, the report does offer observations that the IG believes could enhance the examination process and presents some matters for the Board’s consideration.

The Federal Reserve will carefully review all the matters and lessons outlined in the report. Regarding communication within the System, the final IG report will be distributed to all districts for dissemination to examiners. In addition, the lessons learned and red flags will be incorporated into the supervision function’s new Fraud Information Network, which is accessible to all Federal Reserve examiners. The matter will also be discussed in-depth with System examiners at a major conference early next year in a joint presentation by representatives of the IG’s office and the Federal Reserve Bank of Cleveland.

Conducting surprise examinations and requiring financial statement audits of banks with weak risk management and internal controls are tools that have long been available on a case-by-case basis, but in light of this situation we will consider whether additional guidance for implementing these measures is needed. As the IG report notes, efforts to bolster training in fraud and internal control testing and reconciliation techniques are already underway. In view of the findings of the report, we will consider whether these measures are sufficient or whether further steps are needed.

Board staff appreciates the opportunity to comment on the IG report and welcomes the report’s contribution to understanding the failure of Oakwood. No supervisory program can detect all frauds, and supervisors cannot and should not be expected to prevent all bank failures. Moreover, supervisors are daily faced with judgments on how to allocate their most experienced staff to a wide range of risks and competing demands. Nevertheless, the events described in the IG report are a vivid reminder to all supervisors of the critical importance of the effective execution of risk-focused examinations and of the need to continually review and, where appropriate, refine our supervisory processes and procedures.

cc: Chris Moore  
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